Supreme Court, U.S.
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No. 02-566

IN THE

Supreme Court of the United States

CAROL HARLEY, *et al.*,

Petitioners,

v.

3M COMPANY, *et al.*,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

REPLY BRIEF

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Predictably, Respondents would portray this case as routine and unworthy of the Court's attention. In this supposed routine case, the Secretary of Labor and three national organizations participated as *amici* in merits briefing before the Court of Appeals; the Eighth Circuit panel split 2-1 on the principal question presented; the two government agencies responsible for enforcement of ERISA's fiduciary and funding requirements took the unusual step of urging rehearing and reversal; and the participating judges below split 5-3 on the question of rehearing. This history, as well as the points that follow, confirm that the case is an important one and warrants the Court's intervention and guidance.

This brief response to the arguments in opposition to the Petition will demonstrate that Respondents' attempt to avoid review is built upon misstatements of the record as well as mistakes about the status of the Plan, the importance of defined benefit pension plans, and the need for effective private enforcement of ERISA requirements, all as confirmed by the government's filings below. The opposition is also based upon a strained, wishful reading of the Circuit decisions that ignores the conflicts presented.

I. Respondents' Asserted Factual And Policy Grounds To Avoid Review Are Faulty.

Respondents belittle the undisputed large loss to the Plan from the Granite hedge fund investment. (Resp. Br. 6-7). They suggest that a loss to a pension plan of twenty, thirty, or eighty million dollars[1] or more due to apparent fiduciary misconduct should not trouble participants or warrant judicial action to restore the loss and prevent similar misadventures in the future. Respondents' own conduct refutes their argument. At their direction, the Plan continues to press litigation in the Southern District of New York to recover from brokerage houses some portion of this supposedly trivial loss. *See* Resp. Br. 2 n.3; App. 3a n.4. They also have maintained continuous fiduciary

1. Contrary to Respondents' current position, *see* Resp. Br. 2 n.2, the District Court noted that 3M did not quarrel with this measurement of the losses as of the end of 1997. App. 48a.

liability insurance coverage for losses of this magnitude. The participation of the two federal enforcement agencies and other *amici* also confirms that the loss is not trivial.

Respondents also assert that the case should not be reviewed because the lower court's new rule barring enforcement by plan participants only relates to defined benefit pension plans. (Resp. Br. 5). They contend that these plans are a "small minority" of pension plans. Nothing could be further from the truth. In fact, defined benefit pension plans have been the cornerstone of our pension system throughout the last century. According to the most recent review by the Pension Benefit Guaranty Corporation, there are over 35,000 such private plans providing benefits to over 44 million active and retired participants. Although the overall number of these plans has declined since the 1980's, virtually all of this decline has occurred in plans covering fewer than 1000 participants. Both the number of participants and the number of large plans have increased. *See* Pension Benefit Guaranty Corporation, 2001 Annual Report 9, 13-14 (March 2002). As of January 1, 1999, defined benefit plans held assets of $ 1.938 trillion, and 22.1 million participants (just over 50% of all participants) were covered by plans which were then reporting funding at 100% or greater.[2] *See* PBGC, Pension Insurance Data Book 2001 47, 51, 71, 75 (June 2002). Despite the rise of defined contribution salary deferral and savings plans during the last two decades, defined benefit pension plans remain the principal source of retirement security for most citizens, especially those who are approaching or in retirement.

Respondents next contend that the company's contributions to meet minimum funding requirements for constantly accruing

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2. The 75,000 participants in the 3M Plan were not included in the PBGC's tally of participants in fully funded plans. Its canvass of plan funding relies on plans' annual IRS Form 5500 filings, which report funding under the "RPA 94" statutory methodology. According to the Form 5500 report that Respondents certified and filed with the government, the Plan was underfunded as of January 1, 1999. *See* App. 36a.

pension benefits must be deemed to have restored the loss and mooted the participants' claims. (Resp. Br. 7, 11). Both of the lower courts rejected this argument. The District Court rejected it because it believed that the participants had a right to a fully-funded plan, and unless the contributions had established full funding, the injury to the Plan had not been remedied. (App. 74a). The Court of Appeals also rejected it, ruling that the Secretary of Labor, at least, was authorized to sue to restore the loss. Thus, the loss has not been restored and remains actionable. (App. 12a n.5).[3] Once again, Respondents' own conduct in the New York litigation shows that the loss has not been restored. If the loss had been restored by the company's payment of funding contributions, the Plan would not have any such right of action.

Respondents also attempt to minimize the importance of the case based on the supposed funding level of the Plan. (Resp. Br. 6) As an initial matter, this argument assumes the very point in dispute – whether the temporary emergence of a putative "surplus" under non-statutory measures should override the enforcement scheme crafted with such care by Congress. Passing this defect in Respondents' position, the funding argument is factually incorrect, both for defined benefit plans generally and for this Plan in particular. As this year's corporate reporting and business news analyses illustrate, plan funding levels are ever-changing and now are declining signficantly. Yesterday's temporary "surplus" has become today's looming deficit. Many large defined benefit plans had reported "surpluses" throughout the late 1990's due to the run-up in equity markets. But now that the market bubble has burst, the same

3. As a matter of fact, moreover, the record showed that the company's admitted practice is to make annual contributions only equal to the Plan's "service cost." As recited in Plan actuarial valuations, "The current sponsor funding policy has been generally to contribute service cost." 1999 Plan Valuation, 3M 8th Cir. App. at 3M 0057. "Service cost" is the incremental increase in accrued benefits liability for active employees occurring during the single plan funding year ("normal cost") plus an interest charge to amortize that incremental liability. *See id.* at 3M 0100. The contributions therefore are unrelated to and do not restore the investment losses.

plans are reporting significant amounts of underfunding. *See* Brian-Low & Sidel, "The Pension-Plan Pit: Major Companies Face Shortfall of Billions of Dollars," The Wall Street Journal, Oct. 11, 2002, at C1 ("How quickly fortunes have changed for the S&P 500 pension plans."); Burr, "Aggressive Assumptions: Funding Levels Look Bad Now, But Just Wait Till Next Year," Pensions & Investments, November 11, 2002, at 1; Br. of Pension Rights Center as Amicus Curiae in Support of Petitioners 13-14.

The same trend has affected the 3M Plan, thus exposing the fundamental error in the panel majority's analysis and in Respondents' argument. As they did in the lower court, Respondents persist in misrepresenting the funding level of the Plan, asserting that it "has continued to be overfunded by the measures applied by the courts below" and "was at all times comfortably in surplus." (Resp. Br. 10 & n.7, 6-7). This assertion of full funding is refuted by the company's March 2002 SEC Form 10-K report and the chief financial officer's statements to Business Week in August 2002. *See* Pet. at 24 n.6. Another admission of underfunding comes in the company's most recent quarterly disclosure to the financial community, which was released after the filing of the Petition. On October 21, 2002, 3M revealed that it has "embarked upon a multi-year strategy to fully fund the pension liability in the next three to five years, as we could not fully fund on a tax deductible basis during 2002." In accordance with pension accounting standards, the company will book a charge to equity in the amount of approximately $1 billion in the fourth quarter. *See* October 21, 2002, 3M Company Webcast Announcing Results for 3Q 2002, Statement by 3M Chief Financial Officer Patrick Campbell, excerpt beginning at 52:20 of audio file (available at http://investor.3m.com/ireye/ir_site.zhtml?ticker=MMM&script=1010&item_id=666759; last visited November 24, 2002). Although this disclosure of plan funding is based upon the more optimistic approach of FAS 87, the distinction does not help Respondents, because when funding is analyzed under the more rigorous ERISA statutory measures the underfunding is even more severe.

Respondents also maintain that the lower court's new rule must be understood to apply only to claims for breach of the fiduciary duty of prudence, and not to claims based on breach of the duty of loyalty or conflict of interest. (Resp. Br. 6). However, no such limitation appears in the panel majority's ruling. Respondents' argument also ignores the fact that imprudence violations often violate the duty of loyalty as well, and that, as in this case, the imprudence of an investment in part may lie in terms which create a conflict of interest or opportunity for self-dealing by non-defendant fiduciaries and for which defendant co-fiduciaries may be jointly liable under § 405(a), 29 U.S.C. § 1105(a). Respondents thus are compelled to concede that some, as yet undefined, fiduciary violations ought not be immunized even under the panel majority's new rule. But a plan's funding status, and the supposed lack of "personal injury" to participants will not differ from violation to violation. ERISA contains no hint of an invitation for courts to create a new hierarchy of fiduciary violations. In the face of Respondents' argument, one must wonder what principled basis could be found to bar participant enforcement of fiduciary standards in some cases of large investment losses but to allow enforcement in others, and when and how such a distinction could be made. The lower court did not presume to articulate a basis for selective override of the statute, and Respondents also do not offer one. Thus, the panel majority's new rule cannot be applied as narrowly as Respondents contend.

Respondents next assert that the panel majority's elimination of participant fiduciary enforcement actions in defined benefit plans should not be of concern because the Secretary of Labor can pursue all such claims. (Resp. Br. 8) However, the Secretary's *amicus* filing refutes this rosy view:

> [The ruling below] will create an enormous burden for the Secretary as the only person with standing to bring such suits. . . . Because of limited resources available to enforce pension laws and the vast number of pension plans, however, the Department

> must often rely on private plaintiffs to vindicate their own rights.

Secretary of Labor Amicus Br. in Support of Pet. for Rehearing 1, 12 (May 23, 2002). The severe impairment of effective pension enforcement resulting from the Eighth Circuit's ruling is also discussed in the briefs filed by *amici* American Association of Retired Persons, the National Employment Lawyers Association, and the Pension Rights Center.

Respondents also attempt to divert attention from the fact that the lower court's ruling bars plan participants from seeking equitable relief to prevent plan mismanagement.[4] (Resp. Br. 11 & n. 8) Although Respondents suggest otherwise, a request for such relief has been present throughout both companion cases and was urged in the Court of Appeals. Both the District Court and the Eighth Circuit entered judgment without considering this aspect of the relief sought by the participants or explaining why this additional nullification of the statutory scheme was appropriate. Barring all forms of relief sought by the participants is contrary to settled law that actionable fiduciary violations may occur and be redressed whether or not there has been a concurrent financial loss to the plan. *See, e.g., Leigh v. Engle*, 727 F.2d 113, 122 (CA7 1984). Here, of course, the Eighth Circuit held that a large loss has occurred.[5]

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4. ERISA § 409(a), 29 U.S.C. § 1109(a), provides that a fiduciary "shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary." The record here shows that Respondents for years continued to violate basic rules of fiduciary investment management. In these circumstances, courts grant equitable relief to ensure that investment practices conform to fiduciary standards. *See, e.g., Katsaros v. Cody*, 744 F.2d 270, 281-82 (CA2 1984) (court-appointed asset manager); *Donovan v. Mazzola*, 716 F.2d 1226, 1238-39 (CA9 1983) (court-appointed investment manager). This relief is much different than a general command to follow ERISA, which is how Respondents misconceive equitable powers in these cases. (Resp. Br. 11 n.8).

5. In addition to trivializing the large loss and the fiduciary mismanagement shown in the record, ignoring the Plan's own companion

(Cont'd)

Respondents' supposed factual and policy arguments for denial of the Petition are not supported, and do not alter the conclusion that the case warrants review.

II. Respondents Also Fail In Their Attempt To Obscure The Clear Conflicts Between The Eighth Circuit's Ruling And Other Circuit Precedents.

Respondents also mischaracterize the significance of the precedents in order to obscure the conflicts presented by the Eighth Circuit's ruling. Thus, according to Respondents, only "minor or anomalous disagreements of construction" ensue from the Eighth Circuit's ruling. (Resp. Br. 8) Respondents apparently believe that principles set forth in court rulings are applied only when a new case is a factual clone of the precedent, and that unless and until another case presents identical circumstances, there is no risk that a fiduciary, litigant, or judge would find the Circuit decisions to be in conflict.

On the principal question of enforcement of ERISA fiduciary standards, the Second, Fourth, and Ninth Circuits hold that plan participants may sue to enforce ERISA's strict fiduciary duties because the statute expressly provides them with legal interest to do so on behalf of their plans, even if "surplus" assets alone are affected and the participants' benefits have not been impaired. But the Eighth Circuit holds that, despite the unqualified statutory enforcement architecture, participants are barred from suing to recover losses to their plan because only supposed "surplus assets" have been affected and participants have suffered no "personal injury" to their benefits.

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action to restore the loss, overstating the level of Plan funding, and refusing to acknowledge the participants' prayer for non-monetary relief, Respondents stoop to engage in a groundless, *ad hominem* attack on the motivation of Petitioners and their counsel in pursuing their well-supported claims. (Resp. Br. 7) Despite Respondents' annoyance at being held to account, the participation of the two federal enforcement agencies to support Petitioners' positions confirms that the case presents questions of broad regulatory concern. Petitioners would present additional response but are prevented from doing so by Federal Rule of Evidence 408.

Respondents' attempt to construct distinguishing principles to remove these conflicts is unavailing. (Resp. Br. 15-17) On the question of participant enforcement, each of the conflicting Circuit decisions involved plan assets to which no participant could lay personal claim (indeed, two of the conflicting decisions involved defined benefit pension plans with surplus assets), and the participants' benefits had not been impaired. The courts nevertheless carried out the command of ERISA § 409(a). *See Financial Inst. Ret. Fund v. Office of Thrift Supervision*, 964 F.2d 142 (CA2 1992); *Amalgamated Clothing & Textile Workers Union v. Murdock*, 861 F.2d 1406 (CA9 1988); *Brink v. Dalesio*, 667 F.2d 420 (CA4 1981).

It is not possible to harmonize these conflicting cases based on the nature of the underlying fiduciary misconduct. Although the misconduct varied from case to case, the courts did not limit their strong declarations of ERISA standing to the particular facts presented. Indeed, the variety of factual contexts confirms the breadth of the enforcement rule, and mirrors the statute's unqualified command in § 409(a), 29 U.S.C. § 1109(a), that "any" losses to a plan "shall" be restored by the breaching fiduciary. In *Financial Inst. Retirement Fund*, the disputed surplus assets were to be used to fund benefits for pension plans; the litigation question was which of the plans was entitled to the assets. In *Brink*, the court confirmed that a co-fiduciary (Dalesio) who did not profit from the violations was jointly liable to restore the resulting losses to the plans in response to the participants' suit. In *Murdock*, the fiduciary violation caused the plan to realize a premium return on its assets; the defendant was sued to disgorge the profit he made on his own investment that was facilitated by the plan's investment. In each case, the plan was harmed and participant standing to sue to recover the loss was upheld despite the absence of immediate financial harm to the participants themselves.

Respondents claim that ERISA's protective goals are not thwarted by the lower court's rulings and that investment losses in defined benefit plans should not be actionable by participants. (Resp. Br. 10-11) However, both the Department of Labor and

the Pension Benefit Guaranty Corporation have a more global perspective on effective ERISA enforcement and they reach a contrary conclusion. *See* Secretary of Labor Amicus Br. in Support of Pet. for Rehearing (May 23, 2002); PBGC Amicus Br. in Support of Pet. For Rehearing (May 23, 2002).

Respondents also err in asserting that the ruling below is consistent with traditional trust law. As the Court confirmed in *Mass. Mut. Life Ins. Co. v. Russell*, 473 U.S. 134, 142 n.9, 144 (1985), ERISA endows all plan participants with rights to proper management by their plan fiduciaries. When ERISA's strict fiduciary duties are violated, any participant is authorized to sue on behalf of the plan to restore the loss. ERISA's congruence with trust law, and Respondents' misreading of trust law treatises and the Restatement (Second) of Trusts, are further demonstrated in the Brief Amicus Curiae of Prof. John H. Langbein in Support of Petitioners 10-11.[6]

On the second question presented – whether ERISA § 408(c)(2), 29 U.S.C. § 1108(c)(2), provides an exemption from the prohibited transaction rule against self-dealing, ERISA § 406(b), 29 U.S.C. § 1106(b) – Respondents likewise offer no basis to avoid review. The District Court confirmed that the prohibited transaction claim was squarely presented in both actions (Resp. App. 6a-7a), and the Eighth Circuit found no impediment to reaching and deciding it.

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6. The common law authorities confirm that even where a participant has no personal claim to assets lost due to waste or imprudence, his or her interest in the overall integrity of the trust *res* authorizes suit to obtain relief for the fiduciary violation. Although Respondents contend that the ruling below is consistent with *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432 (1999) (plan amendment authorizing use of plan assets to fund benefits for different group of participants), and *Bennett v. Conrail Matched Savings Plan Admin. Comm.*, 168 F.3d 671 (3d Cir. 1999) (dispute over allocation of surplus assets after termination of ESOP; plan amendment allocating surplus solely among active employees held proper), neither case ultimately involved fiduciary misconduct or a resulting loss of plan assets. Again, Respondents' claim of no loss to the Plan is refuted by their suit in New York.

There is a direct conflict with the Ninth Circuit's decision in *Patelco Credit Union v. Sahni*, 262 F.3d 897, 910-11 (CA9 2001), holding that ERISA provides no statutory exemption from the strict prohibitions against fiduciary self-dealing. According to the Ninth Circuit (and every other court that has addressed the question), when a plan fiduciary (in that case, the insurance broker/plan administrator Sahni) used his authority over plan assets to mark up insurance premiums and set and increase the administrative fees he paid himself from the assets, § 408 provided no exemption for the violation even if the fees were argued to be "reasonable" by some outside measure. But, according to the Eighth Circuit, when a plan fiduciary (in this case, Granite's investment manager) used its authority over plan assets to inflate their value and thereby divert additional plan assets to pay itself increased fees, § 408 exempted this conduct from the ban on self-dealing so long as the resulting inflated fees appeared to be reasonable. The fiduciary, litigant or judge is left to guess which Circuit's rule to apply in self-dealing cases.

Respondents also cannot avoid the Circuit conflict by framing the question as a matter of evidence. (Resp. Br. 18-19) If, as the Ninth Circuit and every other court has held, there is no exemption for self-dealing and thus no factual issue of "reasonableness," then no question of proof needs to be considered in the first place. Moreover, even if an exemption for a self-dealing violation theoretically were available to Respondents, it was their burden to sustain this defense. But they made no effort to show how a fee based on concededly phony asset valuations could be "reasonable" under any set of circumstances.

The Court should resolve these conflicts among the Circuits which directly bear on effective enforcement of the ERISA statute.

CONCLUSION

Petitioners respectfully pray that the Petition be granted and that a writ of certiorari issue to the Court of Appeals for the Eighth Circuit.

Respectfully submitted,

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